

Debt Death and Deadweight

CHAPTER 7

The dog that must bark: the design of a problem solving revenue system

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WIDESPREAD public discontent with taxation is attested in the media every day. International financial institutions like the OECD and IMF repeatedly offer advice to governments on the need to amend fiscal systems, but that advice is never anchored in first principles. As a result, the proposals for what are called ‘reforms’ are shaped to accommodate the defects embedded in current tax structures.

A rare attempt at addressing taxation from fundamental principles was the study commissioned by the London-based Institute for Fiscal Studies. Called *Dimensions of Taxation Design*, a battery of economists was convened under the chairmanship of Nobel laureate Sir James Mirrlees. Their book runs to over 1,340 pages! And yet, there is barely any mention of the one policy that would begin the process of comprehensively solving the significant problems that challenge all nations in the 21st century.

The core problem with the way governments raise their revenue is that their tools of choice inflict severe damage to the wealth and welfare of their nations. This is a wholly avoidable outcome. Social scientists have long known how to fund public services without imposing intolerable costs on people or their communities. But readers of the Mirrlees review have to plough through 800 pages before reaching a reference to the one fiscal policy that is economically optimal and ethically compelling. In discussing the taxes on residential and on commercial property, the authors declare that

‘It would be preferable if both tax bases could be moved to the taxation of the value of land rather than of the property so as to remove the distortion against improvements.’ (Mirrlees 2010: 806)

This observation, noted Martin Weale in his Comment, brought the authors “nearer to *the dog they have not allowed to bark*” (Mirrlees 2010: 834; emphasis added). Weale was the then Director of the National Institute of Economic and Social Research (NIESR), one of Britain’s foremost think-tanks. His appraisal of the treatment of wealth taxation, if it had been incorporated at the top of the Mirrlees review, would have turned the whole exercise on its head. While acknowledging that the authors offer compelling assessments of property taxes, he noted that “they do not follow their argument through to the case for a land tax”. Why was this significant?

‘The argument for taxing land but not other forms of wealth is that the disincentive effects to the accumulation of wealth plainly do not apply to land; the stock is fixed and the tax is non-distortionary. Taxes on land are likely to increase the efficiency with which land is used and particularly so if as in the case of owner-occupation the benefit is currently not taxed.’ (Mirrlees 2010: 835)

Weale then explained how this insight ought to influence the restructure of taxation.

‘Tax policy is not only about the advantages and disadvantages of any individual tax, but also the overall tax package. I argued above that the case for a land tax might be enhanced by the fact that it could be used to replace an array of unpopular and probably unsatisfactory taxes.’

In the United States, the character of the tax system has become a defining issue for the Trump administration. But the debates in Washington, DC, are about cutting the tax rate on the richest income tax payers, or offering fiscal inducements to corporations which have stashed cash piles in foreign havens, beyond the reach of the US authorities. This impoverished public debate will not help to “make America great”. To achieve such an outcome, Congress needs to locate the conversation on the issues that could re-empower the nation by raising productivity. And that means switching the tax base from people’s earned incomes to the nation’s flow of rents.

Prioritising the collection of rent to fund public services achieves much more than just an enhanced flow of material benefits from the economy.

- ▶ Ethical behaviour is enhanced by the incentives that arise when rent, which is socially generated, removes the need for government to target the incomes from working, saving and investing.
- ▶ People are actively encouraged to act as stewards of the environment. Land rent is the product of ecological as well as social endowments, not the personal activities of individuals.

- ▶ Social solidarity is revitalised within flourishing communities, when cities are enriched with a sustainable and growing revenue source to fund the services people share in common.

Each of these issues reinforces the case for fiscal reform. Here, however, I shall confine my observations to the ease with which the United States could redesign its revenue system, and the degree to which public services could be funded out of rent.

The adequacy of Rent

There is sufficient land rent available to deliver adequate funding for all the services that modern government's need to provide to their citizens. That pronouncement is based on my lifetime's study of how America's land markets work, and the negative impact of conventional taxes on productivity. In addition, the global evidence affirms the statement that, if the political will existed, it would be possible to fund all the socially necessary public services out of rent.

- ▶ In the early 1990s I was a financial consultant in several cities in Russia and Estonia. A Russian public resource official estimated the value of land and natural resources was greater than \$3 trillion, providing more than enough land rent to fund all the local and provincial government requirements (Gwartney 2014).
- ▶ Australia has some of the best records available on land rental values. Studies by Terry Dwyer and Bryan Kavanagh concluded land rent represented more than 25% of gross annual domestic product. Australia's land rent is adequate to eliminate taxes on buildings, wages, production, commerce and investment and fund all government services.¹

The cost-effective valuation of land rent can be undertaken with acceptable accuracy and transparency. The efficient system of assessment and collection of land rent would pay for itself many times over as a result of the optimum economic use of the land. Every community that gathers its revenue from land rent enhances the wealth and well-being of its entire population, which means that taxes need not be imposed on employees, producers, merchants and buildings.

1. Terry Dwyer (2003), "The Taxable Capacity of Australian Land and Resources", Australian Tax Forum (Vol.18:1), at <https://www.prosper.org.au/wp-content/uploads/2007/11/dwyer-tax-resources.pdf>

Table 4 shows smoothed land income to be 136.1% as a percentage of company and income tax in 1998/99. This was before Australia's current land price bubble. Using Dwyer's technique, Melbourne real estate valuer Bryan Kavanagh extrapolated the data in a submission to the Australian Treasury, in which he showed land rent to be 32.5% of GDP in the 2006/2007 financial year. Available at http://taxreview.treasury.gov.au/content/submissions/pre_14_november_2008/Bryan_Kavanagh.pdf

The market-based rent of land is the amount that should be paid annually for the exclusive use of the benefits that accrue to each location, or for the use of other rent-generating natural resources.

Land rent varies by location and available amenities. It changes in response to people's competitive desire to occupy sites that are fixed in supply. Demand is the sole determinant of land rent. This means that the amount paid to government is fixed by citizens, not governments.

As the demand for land increases, rent will increase proportionally. This creates the virtuous circle: collecting land rent enables the community to attain a sustainable and growing revenue base. Land is visible and cannot leave the community to evade taxes.

Collecting land rent would reduce land speculation and premature land use, by encouraging compact urban development, making it easier to preserve open spaces for parks, recreation, historic sites and other public purposes. In the process, compact cities reverse the trend to urban sprawl and the detrimental use of farm land in rural areas. Land speculators are encouraged to build or sell to others, to recover their carrying costs, which then delivers a supply of housing to meet the demand for dwellings at prices people can afford.

California irrigation districts

The assessment and taxation of land and property is delegated to the state governments. Most assessments are done at the county level, but a few states do it at the state level (as do most provinces in Canada), with a few at the city level. Most assessors show land and buildings separately; some do not. The data base is accessible to the public, but sometimes charges are made for access to the total jurisdiction database.

Land is easier to assess than buildings. In addition to vacant land sales, teardowns are treated as land sales and every improved sale has a land component that is easy to estimate.

Frequency of assessment is a critical factor. Most states do it on a cycle of three or four years. A few, such as British Columbia, do it annually. New York and a few other states have no requirement and their assessments are very old and do not reflect current market trends.

The property tax is used as a primary source of revenue for funding local government services, infrastructure and public schools. Both land and buildings, which are usually assessed separately, are taxed at the same rate (but see Edward Dodson's account of the Graded Tax in Pennsylvania, where some cities allow a higher tax rate on land value and a lower tax rate on building value). It is feasible to update land value or rental assessments annually at a low cost. The value of land rent can be estimated at a cost which

is very small compared to the revenue to be obtained. These outcomes are not based on theoretical speculation. In California, we have ample empirical evidence to support the claims.

An example of a land value capture system that began initially to fund irrigation infrastructure is California's local irrigation districts. Back in 1886, citizens organised themselves after one California rancher who owned one million acres won full rights to the water of the Kern River. The result was the Wright Act, which permitted local irrigation districts to fund the construction of dams and canals and other infrastructure with bonds that were paid off by land rent. The impact was startling. It took just 10 years for the Central Valley to be transformed into over 7,000 independent farms.

The Wright Act was amended to mandate the total exemption of improvements from the tax base. Irrigation Districts included and taxed land that was used not only for farming but also for residence and commerce within townships. Steadily the Irrigation Districts evolved to fund reclamation, recreation, and electric power. The formerly semi-arid plains of the San Joaquin Valley became the "bread basket of America", one of the most productive farming areas on the planet.

State of California total revenue

The opportunity to test the claim that land rent could provide sufficient revenue to pay for all public expenditure came with a political initiative in my home state of California.

For the 2011 election year, an Initiative was proposed to replace all existing taxes with a land value tax. The plan was to eliminate taxes on sales, income and buildings and replace the lost revenue with a charge of 75% of annual land rental values. I was invited to review the Comprehensive Tax Reform Initiative, as it was called. I estimated that sufficient revenue could be raised from rent to replace the revenue that then flowed to state and local governments. To arrive at this conclusion, I had to evaluate existing data and make adjustments and assumptions to fill the data void.

If the Comprehensive Tax Reform Initiative had become law, the State of California could have replaced all the existing revenue sources yielding \$140 billion in annual revenue. The initiative was submitted to the California Attorney General and California Secretary of State. The Legislative Analyst's office approved a fiscal analysis. Unfortunately, an initiative also required signatures on petitions from 8% of the registered voters before an amendment to the state constitution could be proposed and placed upon the ballot. The cost of securing these signatures was prohibitive, and the initiative did not get on the ballot.

Conclusion

As noted above, the shift to a rent-based revenue system delivers benefits far beyond those of material welfare. Take the case of territorial disputes. The social sharing of rent has a major role to play in diplomacy, when applied as a tool for the peaceful resolution of conflicts over the possession and use of land on the borders between nations. Peaceful resolution would be negotiated by sharing the value of commons rent on surface land sites. This would accelerate economic growth to the advantage of all parties in the dispute, thereby enhancing the solidarity that secures sustainable peace.

If such outcomes are kept beyond people's reach, it is not because of the practical issues relating to the assessment and collection of rent as the public's primary source of revenue. The real obstacle is one of political ideology. If policy-makers are to replace their cosmetic exercises with real reforms to taxation, the dog must be allowed to bark. Politicians need a mandate from their electorates. Therefore, somehow, the need for this conversation must be turned into a central issue about the future of democracy itself.

References

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